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Business as Usual?

"It is in the nature of a speculative boom that almost anything can collapse it....Soon there will be margin calls, and still others will be forced to sell. So the bubble breaks."

— John Kenneth Galbraith, The Great Crash, 1929
Houghton Mifflin Company, Boston

Those who perceive a "new era" of ever-rising productivity and corporate profits are apt to conclude that last month's drop of the major indexes will prove to have been yet another great buying opportunity. We cannot say whether or not this is the case. We do not know if this is finally the end of the legendary bull market, but we are certain that it is a market driven by speculation, not fundamentals. And we fear that the longer this speculative frenzy continues, the uglier the end will be when it comes.

We continue to assert that the supposedly sound economy that is supporting the bull market is actually a debt-fueled, consumption-driven bubble economy. Rather than a "new era" of high-tech productivity and lean-and-meanness that allows the economy to grow without consumer and producer price inflation, it is instead a combination of sluggish productivity growth and a mammoth current account deficit that has kept goods inflation at bay. In fact, fundamentally, the outlook for the U.S. and Europe is for continued and prolonged weakness, which will eventually leave their markets exposed as the paper bulls they are. The crash for the U.S., Europe and many emerging markets is only a matter of time, just as it was for Japan early in this decade and just as it was for Southeast Asia this summer.

In this issue, we provide evidence to refute the notion currently being sold by Wall Street and the Fed that the U.S. debt bomb has been defused. We also take a closer look at the other major imbalances threatening long-term U.S. economic growth, and we show how many apparent signs of economic health are actually illusions. These include corporate profits which (until August at least) had been growing at double-digit rates despite weak revenue growth; cheap labor dressed up as booming employment; inflation that has been tamed only by breaking economic growth; and a budget deficit that is vanishing largely because of the windfalls of the bubble economy and stock market.

THE RISK OF A CRASH

It always was the great mystery, who or what would finally prick the ludicrous bubble in global stock markets as long as Mr. Greenspan and Co. insist on keeping their money spigots wide open. Yet simple logic suggests that any bull market must at some point run out of the Greater Fools that buy from the bulls at ever higher prices. In the United States, actually, cash (is trash) holdings relative to bond and stock holdings are down to their lowest level in history, beating even the lows of the late 1920s.

Could these wild gyrations and slumps in currencies and stock markets still be business as usual? Posing this question, one immediately realizes that the financial world has changed. We recognize behind this turmoil three major catalysts:

- *First,* the violent bursting of the Southeast Asian bubble. Again, supposedly ever-vigilant policy makers and financial markets were completely taken by surprise. Gross imbalances and excesses that have accumulated over years imploded into collapsing currencies, plunging equity prices, skyrocketing interest rates, capital flight and convulsions of the financial systems. The whole region is haunted by a

glut of debt, largely in dollar and yen, and a glut of commercial property and industrial capacity. We think the importance of the financial debacle developing in Southeast Asia for the world financial markets can not be overstated, bearing in mind that the Asian central banks with their massive U.S. Treasury purchases have crucially contributed to maintain and foster the global financial excesses.

- *Second,* U.S. blue-chip profit warnings. Many blue-chip stocks that were the leaders of this long U.S. bull market have been battered on profit warnings, causing losses of 20 percent and more. Coca Cola, Gillette, McDonald's and General Electric are notable examples. With such warnings from high-profile companies, we may finally be at the point where analysts and investors take in this respect a more critical look. To our repeatedly stated profit concerns are now to be added the financial and economic uncertainties in Asia, a region of concentrated investment by the multinationals.

- *Third,* derivatives. The apparent chief propellant of the plunge in U.S. stocks has been a rush of performance-susceptible institutional investors to hedge against losses in such over-owned blue chip multinationals. Rather than sell stocks as they fall, they keep them and hedge their exposure through the derivatives and futures markets. The danger essentially inherent in this popular hedging strategy is that at some point it leads to a self-feeding sell-off, as hedging and selling compound (see "The Hedging Trap," page 11). Stakes are exceedingly high. Thus, we are not surprised when, during critical periods of market weakness, miraculous, late-afternoon "program trading" — which looks more like pure market manipulation — all of a sudden sparks confidence-building rallies. All the same, continuing inflows into mutual funds are giving support to small cap stocks.

TAKING STOCK OF THE U.S. ECONOMY'S HEALTH

Of the many historic narratives about the U.S. stock market boom of the 1920s and the following depression, one sentence in particular has stuck in our mind. It is from Prof. Joseph Schumpeter's History of Business Cycles. Speaking of the Depression, which took everybody completely by surprise: "People, for the most, part, stood their ground firmly. But that ground itself was to give way."

At the time, there prevailed total complacency and misunderstanding about the state of the U.S. economy. In the conventional view, it was healthy as never before. Everything, except agriculture, had boomed for six-to-seven years against the background of absolutely stable consumer and producer prices. In the American consensus view at the time, this prolonged price stability was the hallmark and proof of the "new era" of perfect economic balance and health with high productivity and profit growth from the "industrial "revolution", which together sanctioned ever-higher stock prices.

What is the difference between then and Wall Street's present raving about a "new era"? We have to say that the present proclamations of a "new era" of permanent double-digit rises in profits and stock prices, a "technological revolution," and the glorious defeat of inflation reminds us fatally of the same naïve and absurd chattering of the late 1920s.

"While the media blamed the stock market selling on earnings warnings from Coca Cola and Gillette, their announcements could not surprise any serious analyst. Both companies, and many others, have been reporting stellar earnings reports against the background of most unimpressive revenue growth."

What ought to set everybody questioning the validity of these attempted justifications of the exuberant U.S. stock market in the first place is the fact that these skyrocketing stock prices have been, with few exceptions, a global phenomenon, engulfing numerous countries where economic conditions are either bleak, as in Europe, or chaotic, as in Russia.

How healthy, really, is the U.S. economy? Haven't there been tremendous improvements? Soaring consumer and government debts, for many years the main bogeymen, are according to Mr. Greenspan now well under control. As he explained, debt growth and economic growth are now in singular balance, rising both at a rate of about five percent. What's more, the U.S. economy is enjoying booming investments in equipment.

Enthusiastically appraising this new, unusually modest debt development, a front-page Wall Street article about consumer debt gleefully commented: "This is one of these rare moments when economists look for something, anything, that looks like an imbalance in the U.S. economy. It is getting difficult to find one." Or to quote the chief economist of a well-known U.S. corporation referred to in this article: "It's part of this wonderful economy we're in. You look for imbalances and you can't find them. It's unbelievable."

What are we really witnessing in the United States? A financial mania and highly vulnerable "bubble" economy driven by persistent, excessive monetary looseness or, indeed, a super-healthy and super-efficient "new era" economy? This is the all-important question. But are there reliable measures to answer this question with certainty and accuracy? Yes, they definitely exist.

A comprehensive analysis of financial flows and the pattern of U.S. economic growth makes it perfectly clear that the U.S. economy's outstanding performance in recent years reflects unquestionable "bubble" effects. While the consensus sees neither inflation nor any imbalances, we see the economy riddled with major imbalances.

A DIFFERENT INFLATION

To most people, inflation is a persistent, marked increase in consumer and producer prices. To the economists of the Austrian School, who tend to search for causes, inflation is an expansion of money and credit beyond the needs of economic activity. For them, the rise in the prices of goods and services is merely one of various possible effects of a monetary overexpansion. In fact, the rise in the consumer price index is monetary inflation's most gradual and least important effect.

As we have often emphasized in past letters, the popular terminology is deplorably deficient because it recognizes no other kind of inflationary effect than that which manifests itself in the conventional prices indexes. It is blind to all other possible ill effects of monetary inflation such as trade deficits, rising asset prices or "maladjustments" in the pattern of demand and output. They fail to see that, depending on where the inflated money and credit supply is directed, the effects of monetary inflation on the economy and its price system may vary tremendously.

Conspicuously, the worst episodes of inflation in this century, with the most disastrous economic consequences, were the U.S. stock price bubble of the late 1920s and the Japanese asset bubble of the late 1980s. Both occurred against the background of virtual zero inflation in the price indexes of goods and services, yet both were followed by a devastating depression in the first instance and by a prolonged and deep recession in the second.

The inflation that is presently raging in the financial markets is substantially of the same type as the U.S. brand of the 1920s and the Japanese brand of the 1980s. While stock prices have been soaring to dizzying heights, consumer and producer price inflation have been declining to postwar lows.

From a historic perspective, this development is nevertheless unique in one respect. That is its global extension. Stock and bond markets have been flooded with torrents of money around the world. In the same vein, also around the world, the inflation rates for goods and services have been declining. This unprecedented globalization of the financial boom has had two all-too-obvious causes:

- *First*, uncontrolled and uncontrollable global money and credit creation for leveraged financial

speculation fostered by deregulation, innovation and the abolishment of capital controls;

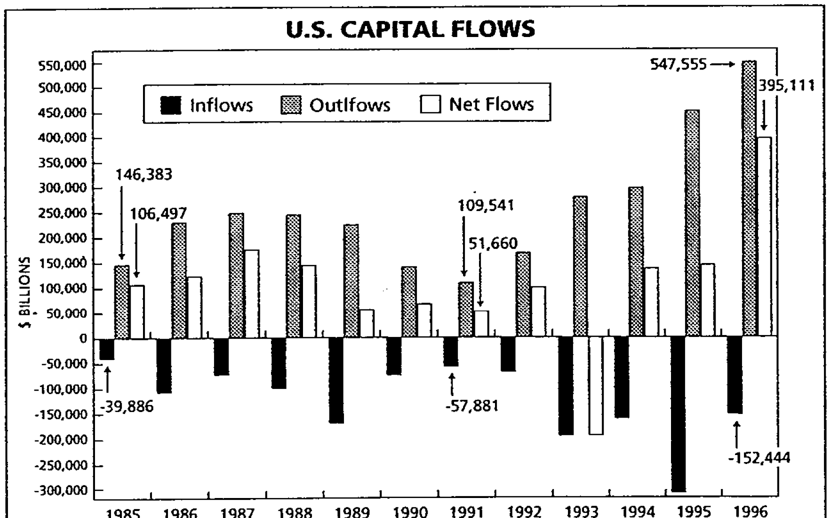
- *Second*, a general, frenzied, desperate search by speculators and investors for higher yields with increasing disregard for risk.

For lack of statistics capturing the huge flows into financial markets, we have come to regard the capital account in the U.S. balance of payments as a rough measure of the virtual explosion of speculative activity in global financial markets. Clearly, things went in 1995-96 completely out of control. During the most recent two years alone, the United States had on top of its current account deficit of $277 billion cumulative money and capital outflows of about $600 billion, versus money and capital inflows of one trillion dollars.

In the last letter, we explained in some detail how this global money and credit spree has financed unbridled financial speculation and how this has come about. We concluded that as a result of persistent, gross monetary overexpansion, the U.S. economy has suffered seven major maladjustments imperiling U.S. long-term growth. Let's take a closer look at them.

PERENNIAL, DEBT-FINANCED OVERCONSUMPTION

Yes, we belong to those ridiculed Cassandras who have been warning that the reckless consumer borrowing binge and spending binge is a recipe for disaster. But the fact that it hasn't happened yet is for us no counter-evidence. Given wide-open money spigots and reckless banks in desperate search of reckless consumers, the game continues apace. Still, the remoter, disastrous consequence remains compelling. To quote Ludwig von Mises on this point: "It may sometimes be expedient for a man to heat the stove with his furniture. But if he does, he should know what the remoter effects are."



Source: Welt Research; US DOC Survey of Current Business, July 1997

Here are the figures that we look at: as of late 1996, household debt totaled 89 percent of annual disposable income, up from 83 percent in 1990 and up from 67 percent in 1980. Is that a sustainable trend, or not? The predictable results have been sharp increases in loan defaults and bankruptcies, even though income growth is at its strongest level in many years.

"In 1996, there were 2.33 dollars added to debt for each dollar added to GDP."

While consumer borrowing has lately slowed, the asset-richer consumers kept the spending spree going by stepping up their realizations of capital gains in the stock market, implying corresponding dissaving. Given both kinds of stimulative influences, consumption has in the 1990s hit an all-time high of 68.6 percent of GDP growth, compared with 65.4 percent in the 1980s and 57 percent in the 1970s.

But to really grasp how fast the U.S. economy is stampeding into overindebtedness, one has to compare current overall debt growth with current GDP growth. The picture which then emerges is diametrically different from that which misled Mr. Greenspan to his complacent assessment of a new balance between the two.

In 1996, the total increase in debt of the nonfinancial sector (government, consumers and businesses) was $751 billion. Compare this with the increase in GDP of just $322.3 billion unadjusted for inflation), and you can easily see that for each dollar added to GDP there were 2.33 dollars added to debt. This is a record imbalance, far more severe than the long-term debt-to-GDP ratio that existed until the early 1980s of 1.30:1. What's worse, shrinking government borrowing has been more than offset by ballooning consumer borrowing.

PERENNIAL SAVINGS INSUFFICIENCY

Established wisdom holds that the levels of savings and investments are the key determinants of increasing productivity and living standards. Remarkably and oddly, none of the apostles of a "new" productivity-led U.S. economy ever mentions the subject of savings, and that has a good reason: America's chronic savings deficiency has in the 1990s deteriorated to its worst in the whole postwar period.

Until the early 1980s, American families saved about eight percent of disposable income. In the 1980s, this rate was down to about five percent. For 1996, it has just been revised downward from an original estimate of 4.9 percent to 4.3 percent, amounting to $240 billion, compared with $260 billion in 1993. Just imagine if Wall Street had to make a living on this trickle of domestic personal savings. Long-term interest rates would be near ten percent or higher. But who needs to care about savings when there is unlimited global money and credit creation for financial speculation?

A PERENNIAL, MAMMOTH CURRENT-ACCOUNT DEFICIT

If Mr. Greenspan and Wall Street have difficulties identifying the consumer debt bubble, there is no excuse at all for their complete disregard of the U.S. economy's most fundamental imbalance. That is the yawning, chronic trade and current account deficit. In the old days of the gold standard, by the way, the balance of payments ranked as the key test of a nation's economic health, and rightly so. Better than any other parameter, it shows whether a country is living beyond or within its means.

Typically, this deficit, now approaching $200 billion annually, is discarded as irrelevant because it accounts for little more than two percent of GDP. Yes, but in ten years that accumulates to 20 percent and a mountain of foreign indebtedness that the children inherit. Since 1984, when this torrent of red ink in U.S. foreign trade started, the United States has racked up over $1.5. trillion in current account deficits. In this staggering amount, goods have flooded in, while scraps of IOUs have flooded out. Given the abysmal productivity growth, one has to conclude that this huge import surplus has been the main source of America's rising living standards during this period.

In essence, such a deficit implies a corresponding excess of spending over output. To maintain it, essentially requires a permanent loose monetary stance that replaces the associated outflow of money for the payment of the import surplus by new money and credit creation.

Even more problematic than the current deficit as such is its financing. For years, private capital inflows have been vastly insufficient to fund the U.S. deficit. Most of the money pouring into the United States during recent years has come from two sources which definitely do not rank as regular investment flows or normal market forces.

These extraordinary dollar buyers, the true purveyors of artificial dollar strength, have been foreign central banks and the world's growing herd of aggressive international speculators, primarily American hedge funds, exploiting the existing big international interest differentials, the so-called global carry trade. As they are largely domiciled in Caribbean places and London, they appear in the U.S. statistics as foreigners who invest in the United States.

While there are no data that specifically capture the global carry trade, it is most significant that in the last

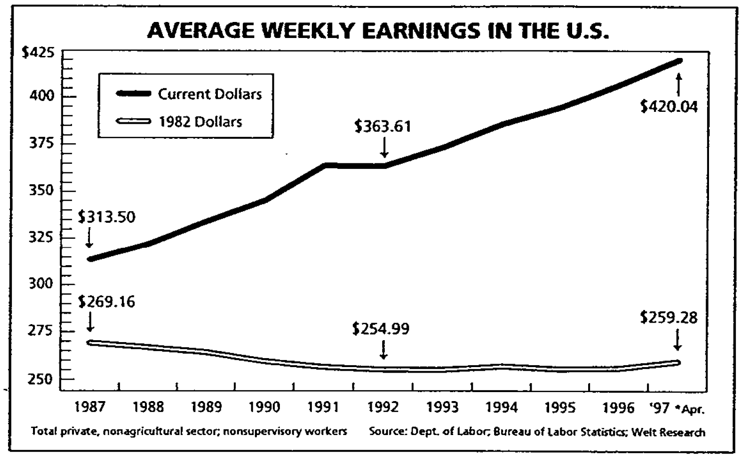
three years the dollar purchases of the central banks alone virtually fully financed the U.S. current account deficit (see August letter, page 8).

In the absence of these massive dirty float interventions of the foreign central banks, Mr. Greenspan would long ago have been forced to hit the monetary brakes. Instead of the "new" American economy, there would have been the spectacle of a crashing stock market and a deep recession.

BOOMING EMPLOYMENT THROUGH CHEAP LABOR

The most spectacular recent feature of the U.S. economy, in particular for onlookers from Europe with its mass unemployment, is its job performance. Since 1991, when this cycle started, employment in the U.S. has risen by more than ten percent or nearly two percent per year. Compared with Europe, where employment has declined by three to four percent during this same time, this is a marvelous achievement.

But compared with U.S. employment growth during the whole postwar period since 1950, this performance is rather less than the postwar annual average, which has run at 2.5 percent during the whole period. However, the decisive difference between past and present is in the wage growth. In the 1950s and 1960s, the U.S. economy possessed the power to provide even stronger job growth with average annual wage rises of three percent in real terms. Living standards zoomed.



Today, average weekly earnings are well below their peak in 1973. After 1973, rises in wage rates were persistently outpaced by inflation for nearly two decades. In the current cycle, it has taken six years for wages just to begin to beat inflation by little more than one percent. That's an improvement from the 1970s and 1980s, but hardly something to be jubilant about. We think that this extremely poor wage performance shows more than anything else how preposterous are the popular comparisons of the U.S. economy's present "excellent" performance with that in the golden 1960s. In those years, annual productivity growth of 2.6 percent allowed ample rewards for shareholders and worker alike. This is not the case today.

THE PRODUCTIVITY MIRAGE

Clearly, higher productivity growth is central to any talk of a "new" American economy. To hear Mr. Greenspan in his last congressional testimony tell it, along with many bulls on Wall Street and assorted chief executives, the U.S. economy has after more than two decades of consumer-led growth entered a new era of productivity-led growth promising that the bullish combination of vigorous economic growth with high profits and low inflation can last forever, reminiscent of the economy's best years.

However, there is one small snag with this vision of the brave new world. Any statistical evidence to support this notion is missing. Indeed, in the Commerce Department's just-completed revision of the national economic accounts, the poor productivity performance of the 1990s was left unaltered. It found that the United States had experienced average annual productivity gains of slightly less than one percent over the past six recovery years, little different from the disappointing gains in the 1970s and 1980s, and substantially less than half the gains in the 1950s and 1960s.

Just recently, quite a publicity fuss was made of a Labor Department report according to which U.S.

productivity gains had in the first quarter spurted to a 2.6 percent annual rate. It was instantly hailed as final proof of the beginning productivity boom. However, it was revised downward to 1.4 percent, followed by a tepid 0.6 percent in the second quarter.

In mid-July, Mr. Greenspan had dangled in front of Congress the probability that an impending major re-benchmarking of the GDP statistics by the Commerce Department for 1993-96 would reveal a faster rise in productivity. This hope of his was occasioned by the fact that over the past years an outsized discrepancy between two different gauges of economic growth had emerged. The one focuses on the growth of incomes (GDI), and the other one on the growth of output and spending (GDP). The income-based measure had been growing considerably faster than the output-based measure.

For the productivity bulls it was a foregone conclusion that the gap in the national accounts would be closed by lifting real GDP growth to the higher GDI level. Thus, "missing" productivity growth would finally surface. However, the statisticians of the Commerce Department were so unkind as to flatly shoot down their bull story. Their growth revision was minimal, leaving the gap untouched.

A BUBBLE WINDFALL BALANCES THE BUDGET

This brings us to another, dubious success story that has substantially contributed to the Wall Street hype — namely, the rapidly vanishing Federal budget deficit. It started with an announcement by the Congressional Budget Office on May 2 that recently skyrocketing tax revenues were promising over the next five years an excess of $225 billion over projected tax revenues. Virtually all of the gains were accruing from one single source: higher-than-expected personal income taxes, nearly all from "nonwithheld" personal income tax payments.

Not surprisingly, this was one of the straws at which the Wall Street bulls immediately clutched as more compelling proof of higher productivity, arguing that such a big rise in income could only have one source: hidden productivity growth. Where else could it come from?

After investigations, the statisticians gave the answer: from financial speculation: The obvious main sources of the huge income and tax windfall were realized capital gains and soaring labor income from the exercise of stock options. The hundreds of billions of income which thus surfaced had everything to do with the booming stock market, and had nothing to do with the coveted productivity gains.

Looking for so-called bubble effects exerted by the soaring stock market on the economy, all too clearly this is one. As pleasant as the tax revenue bonanza is for the time being, it reveals a precarious dependence of the U.S. fiscal accounts on the continuation of the stock market boom. Washington politicians have acted as if the bull market will last forever. They have taken the huge tax windfall resulting from the record-breaking stock market and used it to lower taxes and to increase spending, claiming to have balanced the budget in the process.

THE MYTH OF HIGH TECH SALVATION

In the final analysis, at the heart of Wall Street's exuberance there is a widespread belief in the magic wand of high tech providing a boost to productivity, which allows for persistently higher growth and lower inflation. What the "industrial revolution" did for Wall Street exuberance in the 1920s, the "technology revolution" is doing for Wall Street exuberance in the 1990s.

High tech is nowhere as predominant as in the United States. Riding a wave of technical optimism, the computer, software and communications industries have over the past three years grossly outpaced the rest of the economy and have played the decisive role in extending the current economic expansion. Luckily, the surge in these industries in 1995-96 came just in time, when autos and housing turned down.

After several years of very sluggish investment spending in the later 1980s, U.S. business investment in equipment suddenly took off in 1993. During the four years until 1996, it jumped in real terms by 51 percent. This resulted in the U.S. economy's highest ever investment ratio, accounting for 29 percent of real GDP growth.

But this investment boom was heavily concentrated in one very small segment of the economy: the manufacture of computers and office equipment. Though accounting only for six-to-seven percent of total industrial production, they absorbed almost two-thirds of total new U.S. investment in producers' durable equipment during 1993-96. Technology investment, clearly, has replaced the traditional cyclical industries as the main driving force of the U.S. business cycle.

This big impact of high tech on economic growth through business investment is compounded by the fact that computers have in addition become a big item in consumer spending. Over the past three years, the money spent on home computers has skyrocketed by 55 percent. Propelled by everything from the Internet boom to the stupendous rise of direct-broadcasting satellite television, the high tech sector accounted for a staggering 40 percent of U.S. real GDP growth in 1995 and 33 percent in 1996.

And while evidence of improvement in overall productivity growth is lacking, the computer nevertheless predominates what modest U.S. economic growth there is. In the absence of high tech's tremendous impetus, then, U.S. economic growth would be even more sluggish. But the thing to see is that the dramatic increase in the importance of high tech for the economy arises completely from the *manufacture* of computers, not from their *usage*. Yes, there have been fabulous productivity and profit gains from computers, but they have accrued to their manufacturers, not to their users. Some of them report output gains per worker at an annual rate of between 50-100 percent, enabling them to pocket huge profits while slashing prices.

"The dramatic increase in the importance of high tech for the economy arises completely from the manufacture of computers, not from their usage."

The high tech boom makes for exciting reading, but we wonder about the negative implications for capacity growth. After all, computers are no substitute for goods-producing machinery. During 1995-96, a surge in real investments in computers and information equipment by $71 billion compared with a paltry rise in industrial equipment of $12.5 billion. Considering further that the existing capital stock of the high tech producers is infinitely larger than that of the other part of manufacturing, these numbers suggest from a longer-term perspective a tremendous investment imbalance: gross overinvestment in high tech, versus underinvestment elsewhere in manufacturing.

According to estimates, the capacity of high tech producers has in the last two-three years been growing at 30-40 percent, while capacity growth in the rest of the manufacturing sector has been averaging little more than one percent annually.

Last but not least, one other query springs to mind: Has high tech a downside? You bet, it has. The history of the information-technology industries is anything but smooth. They experienced their biggest downturn in 1985, and in the first half of 1990 business spending on computers slumped before the start of the recession. Nowhere has business proved more volatile than in high tech.

MOSTLY PSEUDO-WEALTH

Ever since the stock market took off into the stratosphere, the pundits and media are raving about the associated colossal wealth. To quote a recent *Baron's* article: "Other markets may have appreciated more since

1982, but nothing in the world can compare with the wealth created here. U.S. equities just hit an astounding $10 trillion in total valuation, up from about $1 trillion in 1982."

It seems to us that leading Wall Street pundits have yet to learn the distinction between two basically different categories of wealth creation:

- *First*, there is wealth that accrues from genuine capital accumulation, that is from additions to capital stock in productive capacity and building;
- *Second*, there exists mere paper wealth that accrues either from rising prices of existing assets or from what in America is sometimes called Ponzi financing, meaning all kinds of unproductive debt, for which all payment commitments are met by new debt.

Authentic capital and wealth creation is confined to the first, measurable by the net increase (after depreciation charges) in the private capital stock of building, plant and equipment. In the 1990s that has been growing by about two percent annually. Despite the high tech boom, it has sharply slowed as computers have rapidly depreciated. Of the valuation and Ponzi prosperity, the old economists spoke derisively of this as "pseudo" or "imaginary" wealth. About government bonds, Karl Marx explicitly said: "These are not capital at all, but merely claims on the annual product of the nation."

The one thing we want to make clear is: America's fabulous growth in paper prosperity adds absolutely nothing to its national wealth. It contains nothing that improves output per worker. Like all inflations, it merely favors one group of the population at the expense of others. But not for long. As such inflationary paper prosperity tends to fuel overconsumption and malinvestments, its final, long-term outcome is general impoverishment.

BREAKING INFLATION BY BREAKING ECONOMIC GROWTH

It is another one of Wall Street's great hype stories that the fundamental changes in the U.S. economy have also tamed the violent business cycle, which had generally been the harbinger of high inflation rates. This tale is often told with self-praise, as the death of the business cycle is said to be due to the newly practiced vigilance of the financial markets. To quote a Goldman, Sachs study, The Brave New Business Cycle: " Despite the age of the expansion, there are few signs of the types of imbalances that normally make the economy vulnerable to downturns. Inventory levels are low; inflation is quiescent; monetary and fiscal policy are close to neutral; and the types of speculative excesses that have often contributed to and/or exacerbated downturns in the past do not appear in the present."

Whatever happens, bad or good, you can be sure that Wall Street makes a bull story of it. What, in the last analysis, has broken global inflation is the breaking of economic growth. Until the late 1960s, sharp and short business cycles went with much higher economic and productivity growth than today. Despite the strong cyclical fluctuations, annual economic growth averaged 3.9 percent, with inflation rates below two percent. This compares with annual average real GDP growth of just under two percent and inflation of just over two percent in the 1990s.

Central to the strong business cycles of the past were strong fluctuations in capital accumulation, i.e. in all kinds of investment spending: inventories, residential and non-residential building, and plant and equipment. But the associated high productivity gains held down inflation. Therefore, to equate the business cycle with higher inflation is ludicrous. The persistently high inflation rates after 1973 came from loose monetary policies in the wake of flexible exchange rates.

In reality, at the root of the so-called beneficial taming of the business cycle is the drastically weaker investment cycle in the industrial countries. Improved control of inventories is the positive part of it. But the

more important, negative part is that the reckless inflationary policies of the 1970s and 1980s have left behind large, chronic maladjustments in the economic structures which are choking long-term growth.

Different countries, though, have undercut their former potential for high growth in different ways. America's most serious inflationary maladjustment consists in the relentless rise of private consumption as a share of GDP as a consequence of the endless consumer borrowing and spending binge. In Europe, the main culprits are the relentless rise in government spending as a share of GDP, associated with a just-as-relentless wage inflation. Japan, in contrast, chose to wreck its former high economic growth potential by the huge, bubble-related, rampant malinvestments in commercial property and industrial capacity, which, when the bubble burst, ravaged and paralyzed Japan's financial system. Having learned literally nothing from the dismal experience of their big neighbor, the Southeast Asian countries also took the inflationary malinvestment route to ruin themselves.

Common to all three inflationary devices that ransack future economic growth — private overconsumption in the United States, public overconsumption in Europe, and huge malinvestments in Japan and SE Asia — is in the last analysis one thing: the ravaging of capital accumulation which alone is able to raise living standards in general. By the way, that's the core thesis of Austrian theory about inflation. Look at the maladjustments, not at the price indexes.

During the later 1980s, the inflationary booms began to display a new, unusual feature: spectacular rises in asset prices. In general, they were concentrated in residential and non-residential property. They were associated with the rapid expansion of credit and money and high inflation rates in the price indexes. The first case of a broader asset bubble, embracing both real estate and financial assets against the background of very low inflation rates for goods and services, was provided by Japan in the late 1980s. Its disastrous ending is well known.

IT IS TRULY DIFFERENT THIS TIME, BUT...

A different case again is the U.S. and European asset bubble of the 1990s. The paramount feature that differentiates it from past cycles is its exclusive concentration in financial assets, bonds and stocks. Its second crucial differentiating feature is the apparent absence of rampant growth in the balance sheets of the banking systems and associated relatively moderate money growth.

Don't let this fool you. There is in reality a runaway monetary expansion, but it is not visible in the published balance sheets of the banks. It is taking place in the buoyant securities markets, on the one hand, and in exploding off-balance-sheet positions of banks, financial institutions and corporations, on the other. The key feature of the first is rampant loan securitization with collapsing risk premiums; the key feature of the second is rampant derivatives trading and speculation.

The only limiting factor to expanding credit today is demand. Deregulation, innovation and globalization make unlimited supply available simply through virtually unlimited facilities to package loans and peddle them to eager investors and speculators. This has transformed many former conservative lenders into aggressive, fee-greedy originators and salesmen of loans.

In the United States, junk bond issuance in corporate and municipal debt is booming as never before. In the banking sector, according to American Banker, syndicated lending for the second quarter was a record $320 billion, a startling rise from the previous quarter of 69 percent, "used mainly for leveraged buyouts".

With considerable losses on auto loans and credit card receivables, Wall Street's securitizing and marketing machinery has turned its attention to mortgages, minimizing down payments and financing the withdrawal of home equity. A California sub-prime lender recently began offering first mortgages of up to 125 percent of home value, if the borrower holds at least ten percent of the mortgage in "liquid assets such as a 401(k)".

While these trends to ever riskier lending should be unsettling to investors, there is little or no concern. Critical to this complacency are other financial engineering strategies that are supposed to "insure" against credit risks. One of these insurance companies, MBIA, recently provided credit insurance that allowed an $85 billion portfolio of Thailand auto loans to be issued at only 18 basis points above three-month US LIBOR. A director at Standard and Poor's commented in regards to this transaction: "If you look at whether the issue is backed by Thai assets or U.S. assets, it doesn't really matter" because of the credit guarantees. MBIA, by the way, has a balance sheet of $411 billion against $2.5 billion in equity capital.

Complacent remarks like these, coming from an officer of a leading credit agency no less, highlight the persuasiveness of the belief that there has been a general reduction of risk globally. For sure, financial engineering has radically changed the perception of risk and thereby the pricing of the actual underlying risk. The result is an ever-aggressive and ill-advised extension of credit to marginal borrowers in the United States and internationally.

We have often thought by ourselves that this simply can't get more manic. But we realize for Wall Street and the world's bankers of today there is no limit to the mania. A huge infrastructure has developed that is working most aggressively and creatively to perpetuate this global financial boom — a boom fueled by haphazard lending and securitization. With the announcements of several high-profile acquisitions, the banking industry is now aggressively targeting Wall Street investment banks to get in on the lucrative action.

THE HEDGING TRAP

The euphoria about the U.S. economy and the prospects for stocks will nor evaporate over night. But all that is required to send stock prices into a steep plunge is that a growing part of the investment community decides to be on the safe side and attempts to insure against further losses through options and futures. In an obviously weak and vulnerable market, the providers of these instruments have no choice but to fully cover themselves by simultaneously selling a corresponding amount of the underlying assets In this way, leveraging all of a sudden works with a vengeance in reverse, from upward to downward, even though market sentiment may have only changed a little. A lot of people may yet have to realize that only individual market players can effectively hedge their exposure in the markets. However, when the "entire" market simultaneously tries to hedge, the system collapses.

During the 1990s the banks turned en masse and aggressively to promoting financial speculation, fueling it with a virtual unlimited supply of money and credit. In its recently filed quarterly report, the Office of the Comptroller of the Currency revealed that the notional volume of U.S. commercial banks' options and other derivatives had increased another nine percent, to $21 trillion. In addition, it stated that the banks had earned $8 billion from proprietary trading. Beyond commercial banks, even more aggressive investment banks, no doubt, particularly profited.

Increasingly, banks worldwide have been profiting handsomely from writing options, mainly puts. Doing this, they accepted the risk of a market drop from a counterpart seeking market insurance. In the long bull market, this was inevitably a very, very lucrative business. What we worry about is how this works in a bear market. Neither these banks nor the whole associated industry have been tested by a prolonged bear market.

Nor has there been much thinking about the most important question: whether and to what extent these derivative markets have contributed to the frenzied run-up in stock prices. In our view, these markets are prone to support and intensify the ongoing trend. For many years, that was up, and one day it will be down. Actually, we see the potential for disaster in a bearish trend. As more and more participants try to hedge against loss, the massive selling simply overwhelms the market. In the crash of 1987, it played the crucial role.

This brings us to the most rampant inflation in the financial markets, namely, derivatives trading that is running into astronomic dimensions but remains completely "off balance sheets". After three years of study, the

Financial Accounting Standards Board (FASB) demanded to make derivative positions more transparent for investors by adopting rules requiring companies to calculate a "fair market value" for derivative positions and report gains in that value in financial statements

That interested banks and businesses vehemently disapprove is hardly surprising. Most astonishing, though, is the opposition of Mr. Greenspan, who opposes it with the argument that it "may discourage prudent risk management activities and could in some cases present misleading financial information."

It is our opinion that the world financial system is overloaded with risks from derivatives and futures positions. And second, far from offering insurance against losses, both markets will aggravate any bear market, once it really starts.

CONCLUSIONS:

Are these gyrations in the global stock markets still "business as usual", that is corrections in a continuing uptrend, as they have occurred before? Who knows? Importantly, the conditions that have fueled this global financial mania — loose money, subdued inflation and doggedly low interest rates — remain in force .The Asian tremors are certain to make it even more compelling.

Nevertheless, several developments portend an increasingly difficult environment for investors. Market volatility has increased dramatically to levels not seen since 1990, and before that, 1987. In the United States, the situation is compounded by the strength of consumer spending — with troubling signs of overheating real estate.

This downturn in stocks is global. Wall Street leads the pack, yet stock markets in Japan and Europe have been hard hit for reasons of their own. SE Asian stock markets are in a meltdown. Few people seem to grasp the potential calamitous global implications of the currency and credit tremors in this region, until recently the world's fastest growing market. Liquidity disappeared virtually overnight.

In this letter, we have taken another long, hard look at the U.S. economy in order to check the Wall Street hype about a "new era" economy. We registered an economy riddled with severe imbalances and bubble effects. The vertical upward path of U.S. stocks in the last two and a half years is littered with arguments about dramatic improvements in the economy's growth fundamentals that are either flatly wrong or irrelevant.

Risks in the stock markets ludicrously outweigh potential rewards. The prospects are for global economic weakness and low inflation. In contrast to the euphoria in the financial markets, the overall performance in the real economies has been persistently disappointing, and it can only get worse. Wall Street has convinced the masses to overpay for stocks more than at any other time. This is the "new era". But this is not the path to prosperity. It's the path to a crash. Only its timing is in question. Historically, every big crash started when people and markets were most complacent.

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